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No.

Supreme Court, U.S.
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In The

Supreme Court of the United States

OCTOBER TERM, 1989

MOR-FLO INDUSTRIES, INC. and
AMERICAN APPLIANCE MFG. CORP.,

Petitioners,

v.

STATE INDUSTRIES, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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Mfg. Co.

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QUESTIONS PRESENTED

1. Whether, contrary to prior case law and the Congressional scheme, damages in the nature of lost profits on an entire device can be awarded in a patent suit based simply on a showing by the patent owner of its market share, where

   (a) acceptable products made by noninfringing methods were admittedly available from the patent owner's major competitor, and competitive products were also available from others, and

   (b) there is no expert testimony of record on damages and no other evidence that but for the infringer making its sales those sales would have been made by its competitors in proportion to their respective market shares.

2. Whether, when a rule of law changing the placement of a burden of proof is adopted for the first time by an appellate court, fairness and due process require that the case be remanded for the affected party to introduce evidence to meet that burden.

PARTIES TO THE PROCEEDINGS BELOW

The parties to the proceedings below are:

1. Defendants-Appellants (Petitioners), Mor-Flo Industries, Inc. and its wholly-owned subsidiary American Appliance Mfg. Corp. (collectively referred to as "Mor-Flo"); and

2. Plaintiff-Appellee (Respondent), State Industries, Inc. (hereafter "State").

STATEMENT PURSUANT TO RULE 28.1

Mor-Flo Industries, Inc. is a publicly held corporation with several wholly-owned subsidiaries.

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1989

No. ___

MOR-FLO INDUSTRIES, INC. and
AMERICAN APPLIANCE MFG. CORP.,

Petitioners,

v.

STATE INDUSTRIES, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI

Petitioners, Mor-Flo Industries, Inc. and American Appliance Mfg. Corp. ("Mor-Flo"), respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Federal Circuit entered August 31, 1989 in this case.

OPINIONS BELOW

The opinion of the United States District Court for the Eastern District of Tennessee on the issue of damages is reported at 8 USPQ2d 1971, while the Court of Appeals affirming opinion is not yet reported. Copies of these opinions, as well as the judgments and orders rendered by the courts in this case, are attached. (A1-65)

Mor-Flo's motion to the Court of Appeals for rehearing was denied. (A21) The Court of Appeals requested a brief from respondent ("State"), however, concerning Mor-Flo's suggestion of a rehearing in banc (A23), and that suggestion is still pending. On motion, the Court of Appeals has stayed the issuance of its mandate for 30 days. (A24)

An earlier opinion of the District Court on the issue of liability is reported at 639 F. Supp. 937. This was affirmed by an unpublished opinion of the Court of Appeals for the Federal Circuit. 818 F.2d 875 (Fed. Cir. 1987). (A66-104)

JURISDICTION

The jurisdiction of this Court to review the decision of the Federal Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

35 U.S.C. § 284, Damages:

Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court.

When the damages are not found by a jury, the court shall assess them. In either event the court may increase the damages up to three times the amount found or assessed.

The court may receive expert testimony as an aid to the determination of damages or of what royalty would be reasonable under the circumstances.

STATEMENT OF THE CASE

This case involves a marked departure from all prior patent cases concerning damages. It is a suit for the infringement of Denton U.S. patent 4,447,377, owned by State, which issued May 8, 1984, on a method of insulating the water tank of a water heater.

For many years, in the low-profit, fiercely competitive water heater market, water heaters have been constructed with a cylindrical outer jacket surrounding the water tank, and fiberglass insulation in the space

between the water tank and the outer jacket. With the requirement for increased water heater efficiency, in the late '70's and early '80's, polyurethane foam insulation has often been adopted in place of fiberglass.

The patent in suit involves insulating the water tank of a water heater with polyurethane foam by wrapping an envelope of plastic film around the water tank -- before installing the outer jacket -- and pouring the foam into the envelope, to keep the foam from leaking out while it is in a liquid state, before it sets.

From 1981 to mid-1986, Mor-Flo used a plastic sleeve or cylinder of film, which it pulled over the top of the water tank (rather than wrapping it around the tank). Mor-Flo cinched the bottom of the plastic sleeve around fiberglass at the lower part of the tank, and then poured foam into the region between the sleeve and the tank.

After Mor-Flo had used this approach for 2 or 3 years, State's patent issued in mid-1984 and this suit followed. When, on May 29, 1986, the District Court found that this method of insulation infringed, Mor-Flo immediately dropped the plastic sleeve, in favor of a noninfringing fiberglass ring positioned to constrain the foam leakage. Thus, the relevant period for assessing damages is from May 8, 1984, when the patent in suit issued, to June 9, 1986, when Mor-Flo's switched to its current method.

Besides Mor-Flo and State, the other suppliers in the field during the relevant time frame included

Rheem Manufacturing Company, State's major competitor, which sold foam-insulated water heaters made by a noninfringing method, and others that sold noninfringing fiberglass-insulated water heaters.[1]

The record reflects that customers were indifferent to how the water heaters were insulated.

Although State's Chief Executive Officer testified that "No, we have not lost an order," and no relevant expert testimony was submitted, the district court granted damages in the form of lost profits on approximately 40% of Mor-Flo's infringing sales -- based on State's 40% market share in energy-efficient gas water heaters.[2] (A36-7, 117-8) The lost profits damages,

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1. The six major competitors were State, Rheem, Mor-Flo, A. O. Smith, Bradford-White and Hoyt.

State's president testified that Rheem was the co-leader with State (A111-12), and State's attorney stipulated at trial that State is "not taking the position that the Rheem gas foam heater infringes the method patent." (*Id.*, A115) Also, the Court of Appeals observed that "The district court may have overlooked that the Rheem patented plastic foam belt might have provided an alternative way to foam insulate heaters . . . ," but the Court found that this was of no consequence in view of its adoption of a "market share" rule. (A17)

2. The lost profits were calculated on an incremental profits basis, on respondent's profits for its entire water heater.

without interest, amounted to $5,336,306. Also, the court granted a reasonable royalty of 3% on the remaining 60% of Mor-Flo's infringing sales (based on the entire price of the water heaters). With prejudgment interest, compounded quarterly, the award totaled $8,884,671 -- which is a life-threatening sum to Mor-Flo.

Thus, Mor-Flo's use of a plastic sheet to restrain the leakage of foam -- which differed from the patented method, and which Mor-Flo could at any time have designed around (and did so immediately when infringement was found) -- threatens to destroy Mor-Flo's viability and the jobs of hundreds of employees.

The Court of Appeals affirmed the grant of lost profits based on State's market share, saying that:

> This is the first time we have considered whether lost profits can be based on market share. Other courts of appeals that have faced the question have found it unnecessary to answer it. (A8)

Also, the Court of Appeals affirmed the district court's grant based on the entire market value of State's water heaters, even though the step of insulating the water tank is only one of numerous steps in the manufacture of a water heater.[3]

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3. The ruling in this case not only resulted in a massive award that threatens the existence of Mor-Flo, it will affect all future patent cases. As reported in the New York Times:

(continued...)

REASONS FOR GRANTING A WRIT

The Court of Appeals ruling in this case has fundamentally -- and retroactively -- altered the law of damages in patent infringement cases. Prior to this case, the law was clear that: a patent owner could not recover a lost profits award from an infringer unless he discharged his burden to show direct or clear inferential proof of such lost profits. The courts permitted the patent owner to prove lost profits by clear inferential proof only if he could show that there was no noninfringing alternative to the patented item, and that the patent owner would, therefore, have made the sales made by the infringer. If the patent owner could not show direct proof of lost sales, or clear inferential proof in the form of no noninfringing alternative, then the patent owner was by statute and case law explicitly limited to a recovery of a "reasonable royalty".

In the present case, there was no direct proof of lost sales amounting to State's market share, and there was no proof of the absence of a noninfringing alternative. But the court below nevertheless allowed the

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[3] (...continued)

> . . . the court recently came up with a market allocation formula to deal with cases in which alternative products do take up some of the market. (A119)

patent owner to recover lost profits based on a "market share" theory. Moreover, this unquestionably dramatic change, which, in effect, shifted the burden of proof to Mor-Flo to show the lack of actual damages, was applied retroactively. This Court should issue a writ of certiorari for four reasons.

First, allowing recovery based on a "market share" theory directly conflicts with the decisions of this Court requiring that in patent infringement cases, actual damages must be proved and may not be assumed.

Second, allowing recovery based on a "market share" theory directly conflicts with the carefully designed statutory scheme for recovery in patent suits.

Third, allowing recovery based on a "market share" theory directly conflicts with all former decisions of the Federal Circuit.

Fourth, if, contrary to precedent and legislative intent, what has passed for decades as settled doctrine is to be repudiated, and a rule is to be adopted that functionally changes and shifts the burden of proof to defendants to show lack of actual damages, then due process and fundamental fairness require that such a rule be applied only prospectively -- at least to the extent of remanding this case for the submission of evidence on this issue, to provide Mor-Flo an opportunity to meet this newly articulated burden.

I. The novel "market share" basis for granting lost profits is contrary to decisions of this Court and destructive of American industry.

In Seymour v. McCormick, 57 U.S. (16 How.) 480, 490 (1853), this court stated that in a patent infringement suit:

> Actual damages must be actually proved, and cannot be assumed as a legal inference from any facts which amount not to actual proof of the fact.

This rule has been applied to cases involving lost profits under the current Patent Act of 1952, as follows:

> A patentee may recover lost profits by proving that but for the infringement, the patentee would have made the sales the infringer made, charged higher prices, or incurred lower expenses. . . Otherwise the patentee may recover only a reasonable royalty. Amstar Corp. v. Envirotech Corp., 823 F.2d 1538, 1543 (Fed. Cir. 1987).

Proof of a patent owner's market share cannot meet the requisite "but for" causal relationship, between an infringer's sales and a patent owner's loss of sales, unless the patent owner proves that his sales were in fact lost in keeping with his market share. It is not enough that a patent owner merely establish that he has a certain market share -- for a court to conclude, *ipso facto*, that, had the infringing products not been sold, all competitors, including the patent owner,

would have shared in those sales according to their respective market shares. Such a rule would replace actual proof with speculation, and establish a presumption of lost profits that improperly shifts the burden of proof from the patent owner to the infringer. *Cf.*, *e.g.*, Dobson v. Hartford Carpet Co., 114 U.S. 439, 444 (1885) (burden is on the patent owner).

In this regard, the Court of Appeals stated that:

> State was a nationally recognized leader in the industry, and it produced specific evidence that it had lost sales to Mor-Flo's infringing heaters on both coasts. For example, a retailer of State's heaters in California testified that he lost sales to a developer for 3,000 heaters annually to Mor-Flo. Another retailer testified that he lost sales to Mor-Flo in Connecticut. There is nothing speculative about these losses. After finding that State had sufficient marketing and manufacturing capabilities to meet its market share of the demand it is eminently reasonable for the district court to infer that State could have sold its market share of Mor-Flo's infringing sales wherever the opportunity occurred. (A13)[4]

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[4]. The so-called lost sales for 3,000 heaters a year involved an inquiry by a California plumbing contractor, who did work for a developer, as to the price of State's water heaters. (A113-4) There was no proof whether this occurred on the first day of the two-year damages period or the last; nor the number of heaters the plumbing contractor sought to purchase, if any. (*Id.*) Assuming, however, that it occurred on

(continued...)

As indicated by the record in this case, State introduced the testimony of three of its distributors, from California, Virginia and Connecticut. In California, where most of Mor-Flo's infringing sales occurred, Mor-Flo had approximately 70% of the market, and a competitor selling fiberglass-insulated units had approximately 20%. State, Rheem and two other competitors, together, had only approximately 10%. It is pure speculation to say that, from the first day of the two-year damages period, State would have increased its sales in California some fourfold (from appreciably less than 10% to 28%, i.e., 40% of Mor-Flo's 70% market share in that market) -- based on the fact that its national market share was 40%.

State's distributor in Virginia testified that he would guess that he had 60 to 70% of the water heater market for new construction in his region, but no evidence was introduced as to the market share of any of the other competitors in that area. Again, one can only speculate on whether, and to what extent, State's sales might have increased in the absence of Mor-Flo's.

In Connecticut, no evidence of market share was presented.

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[4] (...continued)
the first day of the period, and that it was incident to the developer's total needs for two years, none of which has been proved, it would involve 6,000 water heaters -- out of Mor-Flo's national sales over the two-year period of more than 750,000 heaters.

Further, approximately 25% of State's sales were to Sears, and there is no indication that either Mor-Flo or Rheem or others sold to Sears.

These factors and other vagaries in the marketplace show the inapplicability of a national market share as a reliable test of lost profits -- in the absence of proof by the patent owner that establishes the fact of its reliability in a particular case.

A rule that market share alone is sufficient to bring into play potential liability for a competitor's lost profits, coupled with a liberal view on what is patentable and when lost profits may be awarded on an entire product, not only has devastating consequences in this case; it will have a chilling effect on competition. In this climate, the change of any trifling step in production, such as using a sheet of plastic film to prevent foam leakage, may be a catalyst for financial disaster -- and it will have to be avoided, lest a company's future be placed in jeopardy -- a foreboding prospect for American industry.

II. The "market share" theory is contrary to the Congressional scheme for recovery in patent cases.

Congress has not been inattentive to the nature and quantum of recovery in patent cases. The Seymour case was decided under the Patent Act of 1836. Act of July 4, 1836, ch. 357, §§ 14, 17; 5 Stat. 117. In an action for damages under the 1836 Act, or the suc-

cessor Revised Statutes of 1874, if the rigorous proof requirements to establish actual damages were not met, a patent owner would often be awarded only nominal damages. Coupe v. Royer, 155 U.S. 565, 583 (1895); Keystone Manufacturing Co. v. Adams, 151 U.S. 139, 149 (1894); Black v. Thorne, 111 U.S. 122, 123 (1884); Garretson v. Clark, 111 U.S. 120 (1884).

This Court's opinion in Dowagiac Mfg. Co. v. Minnesota Plow Co., 235 U.S. 641, 648 (1915) alleviated that situation by providing an alternative course, holding that it is "permissible to show the value [of what was taken] by proving what would have been a reasonable royalty, considering the nature of the invention." Congress followed this lead in its 1922 Amendment of Section 4921 of the Revised Statutes, by providing that if the patent owner has proved the fact of damages, and the quantum is "not susceptible of calculation and determination with reasonable certainty," the court may receive expert testimony and award "a reasonable sum" as general damages. (R.S. 4921 as amended by 42 Stat. 392 (1922)). (A105) The same provision also applied to the recovery of the infringer's profits.

This marked the first legislative authorization for awarding "a reasonable sum" where the quantum of actual damages could not be established with the requisite degree of certainty -- but there was no retreat from the

exacting proof that had been required for the recovery of actual damages.[5]

Thereafter, a 1946 Amendment to Section 4921 again addressed the issue of recovery in patent cases. R.S. 4921 as amended by Act of August 1, 1946, ch. 726, 60 Stat. 778. (A107-8) This Amendment resulted in the elimination of the infringer's profits as an element of recovery, Aro Mfg. Co. v. Convertible Top Co., 377 U.S. 476, 505 (1964), while again addressing the alternate to actual damages.

In the 1946 Amendment, and its codification in the current Patent Act of 1952, Congress made the alternative to actual damages mandatory, rather than permissive, by mandating that the court shall award damages adequate to compensate for the infringement but in no event less than a reasonable royalty. 35 U.S.C. § 284. Moreover, for the first time a Patent Act made explicit that interest is also to be awarded. General Motors Corp. v. Devex Corp., 461 U.S. 648, 651 (1983). Again, however, Congress made no retreat from the

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5. The "reasonable sum" provision in the 1922 Amendment was equated to a "reasonable royalty", and viewed as a tolerable substitute for proof of actual damages in cases where the quantum of actual damages could not be satisfactorily established. Wallace & Tiernan Co. v. City of Syracuse, 45 F.2d 693, 695 (2nd Cir. 1930) (L. Hand); *and cf.* Egry Register Co. v. Standard Register Co., 23 F.2d 438, 442 (1928).

long-standing rigorous proofs required for actual damages.[6]

Thus, the Congressional scheme has left intact the rule that actual damages in a patent suit, which may take the form of lost profits, must be actually proved. To avoid leaving a patent owner who fails to meet this test with nothing but nominal damages, however, Congress first authorized the courts in 1922 to award a reasonable sum, and since 1946, it has mandated that the courts shall in no event award less than a reasonable royalty, as well as interest.[7] There is no room in

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6. Similarly, in patent suits against the Government under 28 U.S.C. 1498, which has a compensation provision that parallels Section 284 of the 1952 Act, Devex, 461 U.S. at 656; Waite v. United States, 282 U.S. 508 (1931), the long-standing rule has been that:

> If lost profits are ever to be awarded under § 1498, it should be only after the strictest proof that the patentee would actually have earned and retained those sums in its sales to the Government.

Tektronix, Inc. v. United States, 552 F.2d 343, 349 (Ct. Cl. 1977).

7. While a reasonable royalty award presupposes that "some damages" are awardable, Aro, 377 U.S. at 505, it is noteworthy that Section 284 provides that the court may receive expert testimony "as an aid to the determination of damages or of what royalty would be reasonable under the circumstances." This is expressive of Congress' view that a de-

(continued...)

this Congressional scheme for a judicial detour to a rule that proof of a patent owner's market share is all that it takes to prove actual damages.

III. The "market share" basis is also contrary to all former decisions of the Federal Circuit.

The decisions of other panels of the Court of Appeals for the Federal Circuit granting damages based on lost sales, and consequent lost profits, have uniformly required either direct or clear inferential proof of lost sales, the inferential proof being in the form of proof by the patent owner that there were no available alternatives. *See, e.g.,* Central Soya Co., Inc., 723 F.2d 1573, 1578-9 (Fed. Cir. 1983); Gyromat Corp. v. Champion Spark Plug Co., 735 F.2d 549, 552 (Fed. Cir. 1984).

Thus, the lost profit awards that have been approved by the Federal Circuit have been based on (1) direct proof of actual head-to-head bidding that resulted in lost sales to the patent owner, Bott v. Four Star Corp., 807 F.2d 1567, 1570-71 (Fed. Cir. 1986), (2) direct proof in the form of a market survey to establish

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[7] (...continued)
termination of damages and the setting of a reasonable royalty are alternate approaches (the former of which has required actual proof since prior to this Court's ruling in Seymour).

that the infringer's customers would have purchased from the patent owner, Bio-Rad Laboratories, Inc. v. Nicolet Instrument Corp., 739 F.2d 604, 616 (Fed. Cir. 1984), or (3) inferential proof establishing the absence of noninfringing alternatives, such as where there are only two competitors in the field, Lam, Inc. v. Johns-Manville Corp., 718 F.2d 1056, 1065 (Fed. Cir. 1983), where there are more than two competitors but no acceptable noninfringing alternative product, Panduit Corp. v. Stahlin Bros. Fibre Works, Inc., 575 F.2d 1152 (6th Cir. 1978), or where a submarket exists that is predicated on a demand for the patented product, Yarway Corp. v. Eur-Control USA, Inc., 775 F.2d 268, 276 (Fed. Cir. 1985).

In sum, in all of the cases that have awarded lost profits based on an inference that the patent owner would have made the infringer's sales, the crucial predicate for the inference has been the absence of any acceptable noninfringing alternative.

A market share distribution, on the other hand, presupposes that there were noninfringing alternatives available to customers, and speculates, without proof, that all suppliers would have shared in the infringer's sales according to their respective market shares. In the present case, foam-insulated water heaters made by a noninfringing method, and fiberglass-insulated units, were readily available and competing in the market.

This rule, which results in a mammoth award where damages have not been proved, will find its way into

every patent suit, to produce confiscatory awards, and prove devastating to American industry.[8]

IV. Fairness and due process require that where a rule affecting the burden of proof is changed on appeal, the affected party be given an opportunity to present evidence.

Prior to this suit, in the absence of direct proof that establishes the magnitude of the claimed lost sales, the burden fell on the patent owner to prove that there were no available noninfringing alternatives. This State could not do, and consequently, the burden should not have shifted to Mor-Flo to go forward with the evidence. According to the Court of Appeals ruling, however, proof of "market share" creates a presumption of lost profits to the extent of the patent owner's market share, placing on Mor-Flo the burden of disproving the applicability of a market share/causation relationship.

This being the case, if this newly-articulated "market share" rule is to stand -- and change the rules in the middle of the game -- fairness and due process

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8. This is particularly true since both lost profits and reasonable royalty are being predicated on the entire value of the products -- only a small portion of which has any relation to the asserted invention. *Per contra, see* Westinghouse Co. v. Wagner Mfg. Co., 225 U.S. 604, 615 (1912); Dowagiac Mfg. Co. v. Minnesota Plow Co., *supra*, 235 U.S. at 646-7.

demand that the case be remanded to the District Court for the submission of evidence on this issue, to provide Mor-Flo an opportunity to meet its burden under the new rules. *See, e.g.,* Westinghouse Co. v. Wagner Mfg. Co., *supra*, 225 U.S. at 622-3; Dowagiac Mfg. Co. v. Minnesota Plow Co., *supra*, 235 U.S. at 650-51.

CONCLUSION

For the reasons stated, it is urged that this petition for a writ of certiorari be granted to right a wrong of enormous proportions and overwhelming public interest.

Respectfully yours,

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